State of New Mexico
LEGISLATIVE FINANCE COMMITTEE

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Director

April 11, 2011

MEMORANDUM

TO: Representative Luciano "Lucky" Varela, LFC Chair, and Members of the 2010 Legislative Finance Committee

FROM: Michelle Aubel, Senior Fiscal Analyst MA by MGW

SUBJECT: LFC Report of Investment Performance – FY2011 Second Quarter

Investment Performance Highlights:

- All funds ended up for the quarter ending December 31, 2010. Including investment returns, contributions and distributions, the state's aggregate fund value has gained $4.4 billion since July 1. However, this combined value remains almost $3.7 billion below the September 30, 2007 high of $38.7 billion.

- All funds achieved one-year results above the 60/40 index of 12.1 percent, although ERB fell below this benchmark for the quarter due to its reduced exposure to equities during a robust equity market. Relatively high allocations to domestic equity market rewarded the permanent funds during this bullish quarter.

- ERB remains the only fund to outperform its internal benchmark for all three time periods (3 months, 1 year and 5 years).

- Manager underperformance during 2008 and most of 2009, as well as prior board decisions, continue to detract from this longer-term measure for PERA.

- After beating their internal benchmarks for the first time in several months in the first quarter, the State Investment Council (SIC) managed Land Grant and Severance Tax Permanent Funds (LGPF and STPF) fell below their respective benchmarks in the second quarter by 50 basis points[1].

- Economically targeted investments (ETIs) remain a significant drag on STPF investment performance, representing the primary difference between LGPF and STPF performance.

- Peer rankings for all funds are improving for longer periods, although PERA and SIC-managed funds still fall within the bottom half of their respective peer groups. PERA falls in the 95th percentile for the five-year comparison.

- Longer term returns remain below targets of 8 percent for the pension plans and 8.5 percent for the permanent funds needed to fund obligations. The pension valuations as of June 30, 2010 were released this quarter, confirming projections of declined funding status mainly due to 2008-2009 market losses.

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[1] Basis Points (bps) represent a hundredth of one percent. For example, if the LGPF has underperformed its quarterly benchmark by 170 bps, then it has underperformed by 1.7%.

FUND ASSET VALUES

Total asset values for all funds continued to rebound in the second quarter of FY11, although at a slower pace. Including contributions and distributions as well as investment returns, ERB saw an increase of $400 million compared to $625 million for the first quarter, and PERA increased its total assets by just over $700 million compared to almost $1 billion increase seen from July through September 2010. The permanent funds saw gains of 7 percent and 5.7 percent, compared to 7.9 percent and 6.7 percent, respectively. The combined asset value for all funds has climbed by $3.5 billion for the past twelve months. Most notably, ERB has made up the nominal $2 billion lost in the FY08 and FY09 down markets but remains behind its high water mark of $9.6 billion. PERA, which lost over $4.2 billion during the market dislocations, still has $1.5 billion nominal value to recover. The fund's high of September 30, 2007 was $13.5 billion.

Current Assert Values* (millions)
For Quarter and Year Ending December 31, 2010

	ERB	PERA	LGPF	STPF	TOTAL
Current Asset Value	$9,203	$11,786	$10,212	$3,797	$34,999
Value Change - Quarter	$400	$719	$664	$206	$1,989
Percent Change - Quarter	4.5%	6.5%	7.0%	5.7%	6.0%
Value Change - Year	$925	$1,189	$1,139	$249	$3,503
Percent Change - Year	11.2%	11.2%	12.6%	7.0%	11.1%

*Changes include investment returns, contributions and distributions.

ACTUAL VS. TARGET ASSET ALLOCATIONS

The target asset allocations shown below represent each fund's plan structure. Attachment A provides detail on how each asset class contributed to the funds' overall return as well as compared to benchmarks. In general, all asset classes posted positive returns except for core fixed income, with domestic equities outpacing all others.

Fund Asset Allocation Detail, Quarter Ending December 31, 2010

	ERB*		PERA*		LGPF*		STPF*	
	Actual	Target**	Actual	Target**	Actual	Target	Actual	Target
US Equity	28.5%	25.0%	29.3%	27.0%	45.2%	51.0%	38.7%	48.0%
International Equity	17.6%	20.0%	27.7%	27.0%	14.7%	10.0%	16.3%	10.0%
Fixed Income	31.0%	33.0%	23.9%	26.0%	16.8%	15.0%	10.5%	11.0%
Total Alternatives	16.6%	17.0%	18.7%	20.0%	18.7%	24.0%	22.0%	31.0%
Private Equity	3.8%	2.0%	3.1%	3.5%	8.8%	6.0%	11.5%	12.0%
Real Estate/Real Assets	5.7%	5.0%	6.3%	6.0%	3.4%	3.0%	4.5%	3.0%
Absolute Return	7.1%	10.0%	9.3%	10.5%	6.5%	15.0%	6.0%	15.0%
Other								
Global Asset Allocation	5.5%	5.0%						
ETI***							7.6%	1.0%
Cash Equivalents	0.8%	0.0%	0.4%	0.0%	4.5%	0.0%	4.8%	0.0%
Total Fund %	100%	100%	100%	100%	100%	100%	100%	100%

**All funds are reducing exposure to equities and increasing other asset allocations.*
***Due to the long implementation period for some alternatives, both PERA and ERB have adopted interim targets.*
****ETI: Economically targeted investmetns include state private equity.*

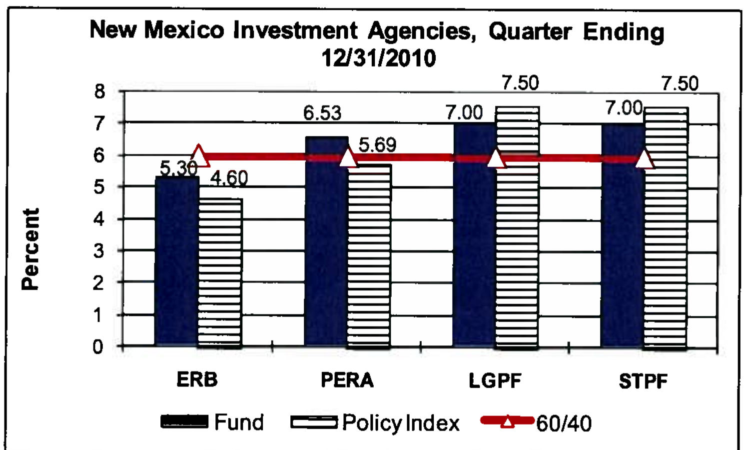
Policy Impact. The effectiveness of plan structure can be measured by comparing the fund's policy index to the median fund's performance. ERB's lower allocation to equities of 46 percent compared to the peer median of 55 percent cost the fund 140 bps. With its relative overweight to equities, LGPF reported 240 bps of policy outperformance. As can be seen from these examples, asset allocation remains a potent determinate of fund performance. This quarter, in particular, brought into focus distinct patterns emerging for the new portfolio models being constructed since passage of the Prudent

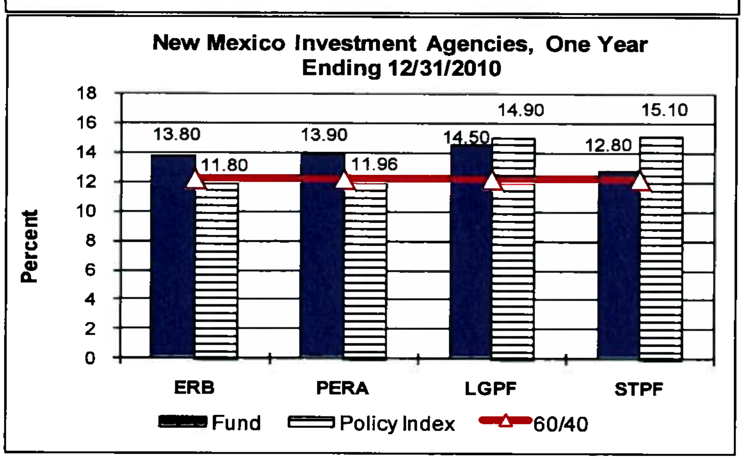
Investor's Act, which allowed New Mexico funds greater flexibility in positioning across various types and weights of asset classes to increase diversification. How New Mexico's transition along these lines translates into meeting long term goals remains to be seen.

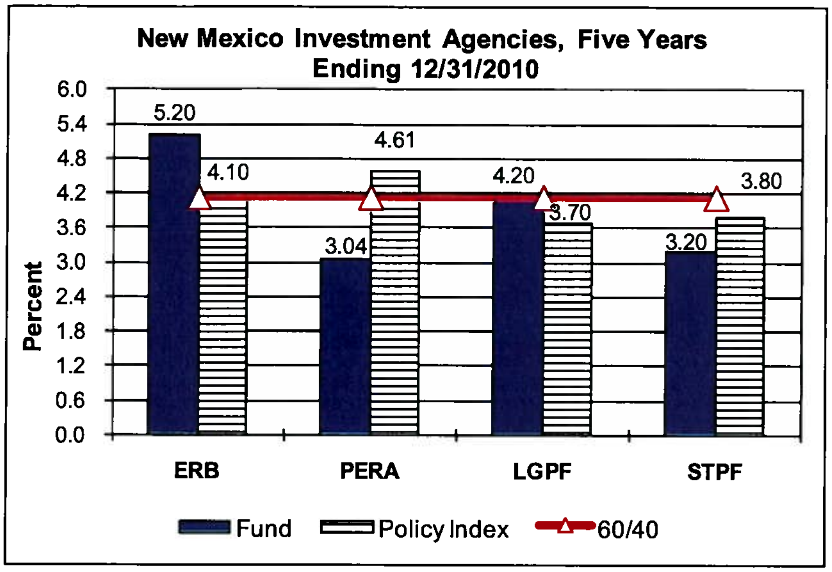
COMPARATIVE PERFORMANCE

For the quarter, all funds reported gains. PERA, LGPF and STPF beat the 60/40 index, which is a hypothetical, "buy and hold only" portfolio of 60 percent stocks and 40 percent fixed income that represents a passive, minimally-diversified baseline. Using this baseline provides insight into the effectiveness of each fund's method for diversifying into alternative strategies since 2005. For example, PERA's portable alpha program, a combination of equity futures layered on top of a hedge fund portfolio, added 279 bps of relative outperformance this period. This boost is a primary driver of PERA's results for the quarter and explains the difference between ERB and PERA performance, given about the same allocation to domestic equity and normal returns from other asset classes.

Performance vs. Internal Benchmarks. ERB remains the only fund to outperform its internal benchmarks for all time periods, indicating a sustained ability to add value through active management, portfolio tactical decisions or longer term asset allocations. After outpacing internal benchmarks in the first quarter, both permanent funds fell behind their respective benchmarks in the second quarter by 50 bps. Economically targeted investments (ETIs) remain a significant drag on STPF investment performance, representing the primary difference between longer term LGPF and STPF results. Much debate has arisen regarding the merits of the ETI program; benefits remain uncertain.







PERFORMANCE RELATIVE TO PEERS

Because of ERB's reduced exposure to domestic equities and absence of a portable alpha program, under normal conditions the fund can be expected to underperform peers as well as the 60/40 index during bullish periods and outperform these measures during market downturns. This pattern can be seen in fund's low relative ranking for the quarter and the higher ranking for the five-year period. Stellar performance for alternative classes and strategic allocations to stressed debt for the last six months of FY10 buoys up the one-year ranking while dismal performance during the 2003 market downturn continues to weigh down the 10-year measure. That poor performance was the driving factor in ERB's revised asset allocation model that has reduced equities from 70 percent since 2005.

Peer Percentile Rankings*

	QTR	1 Year	5 Year	10 Year
ERB	78	28	18	74
PERA	23	40	95	82
LGPF	12	82	71	77
STPF	34	87	87	87

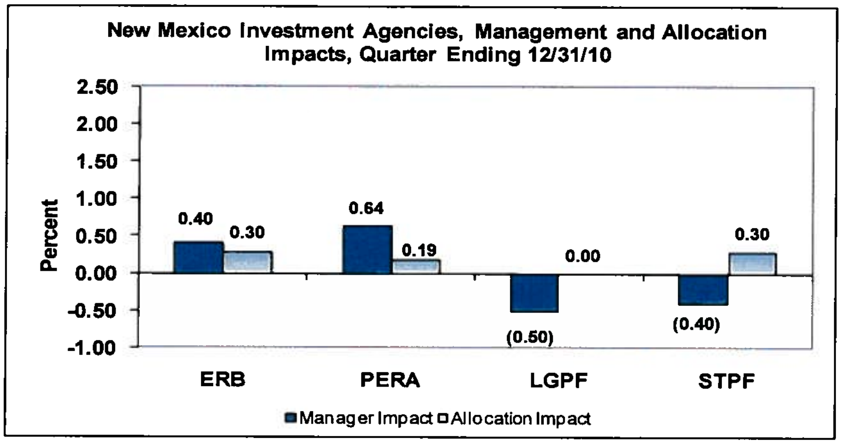
* Percentile rankings (1 is highest) for ERB and PERA relative to U.S. Public Funds.
Permanent Funds ranked relative to U.S. Endowment Funds.

Conversely, SIC funds' higher target allocation to domestic equities relative to peers produced the best quarterly peer rankings SIC has seen since March 2010. One-year rankings have dramatically improved from the 99 percentile scores reported September 2009. PERA remains the only fund in the bottom decile of its peer group for the five-year period.

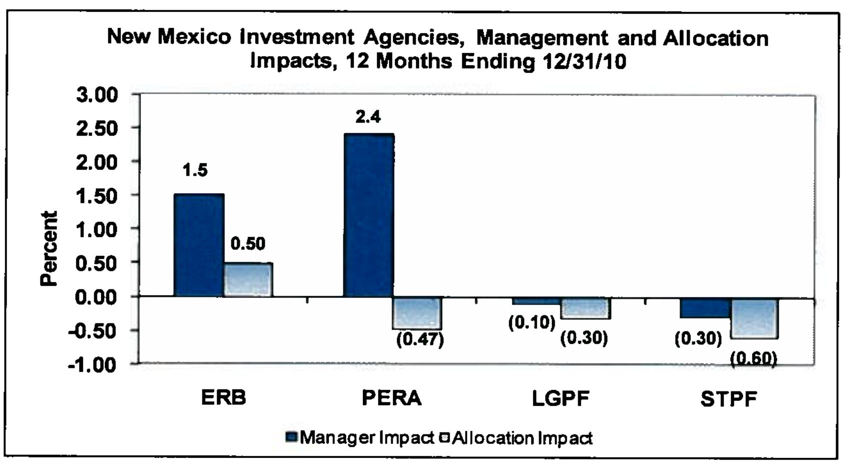
MANAGER AND ALLOCATION IMPACTS

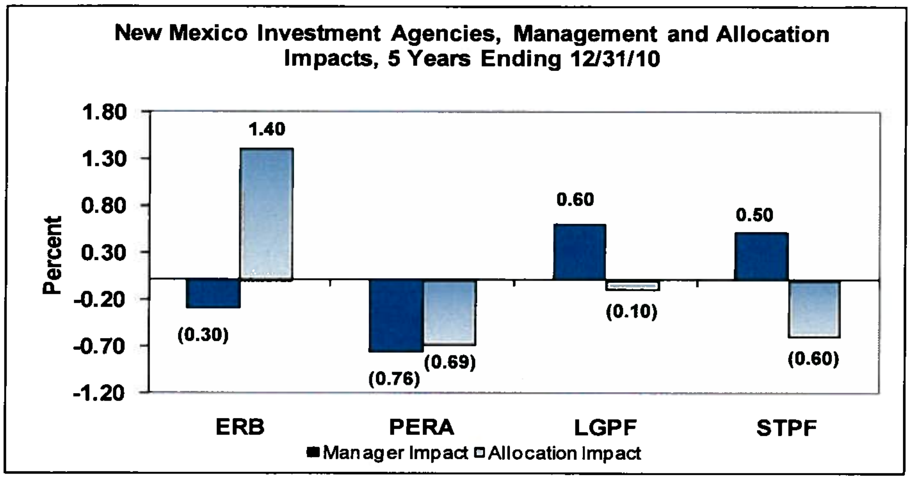
Indexed assets will move as the market moves while active management is aimed at producing a higher return based on the manager's skill at taking advantage of market inefficiencies. Attachment A shows how active management for each asset category either added or detracted value by comparing results to respective benchmarks. Overall scores for active management can indicate the success with which plan administrators are hiring good managers. Allocation impact reflects how deviating from the target asset allocations either adds or detracts from performance. Deviations can occur due to market conditions moving the asset value—which may trigger rebalancing the class to within the targeted range—or through tactical decisions made by the boards.

For the quarter, both ERB and PERA benefitted from active management while SIC managers underperformed as a whole. In particular, Courtland Partners real estate portfolio, lagged by one quarter, hit the Land Permanent Fund by -790 bps. Other alternative managers also underperformed, producing a headwind that was not surmounted by strong outperformance in the fixed income managers and structured debt.



Longer term values are improving for the pension funds, with one-year active management particularly robust. Active management for SIC continues to lag for this period, although the five-year management attribution is positive—most likely due to the hedging strategies used during the worst market times that protected asset value. (See Special Focus: *Hedging of Domestic Equity Exposure by SIC*, LFC FY09 3rd Quarter Report.) The impact of the PERA board decision to underweight equities in March 2009 right before the market rebounded, a tactical decision, can be clearly seen in the negative allocation impact for the five-year period. Also of interest, the same portable alpha program that boosted returns for this quarter placed a significant drag on performance during the market meltdown of 2008, reflected in PERA's negative five-year manager impact.





PERFORMANCE SUMMARY – Fund Performance vs. Benchmarks

Despite strong investment gains for FY10 and for the first six months of FY11, longer term returns remain below the targets of 8 percent for the pension plans and 8.5 percent for the permanent funds needed to fund obligations. During this quarter, both pension plans released their June 30, 2010 valuations, which showed continued declines in funded status due primarily to FY08-FY09 investment losses. Funded ratios (actuarial value of assets on hand compared to the value of obligations) were reported at 65.7 percent for ERB and 78.5 percent for PERA. The minimum industry standard is 80 percent.

Public Employees Retirement Association (PERA)								
1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
13.90%	11.96%	40	3.04%	4.61%	95	4.72%	4.53%	82
Median Fund Performance		13.49%	Median Fund Performance		4.64%	Median Fund Performance		5.20%
*PERA also has a long-term 8% actuarial benchmark for funding purposes.								

Educational Retirement Board (ERB)								
1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
13.80%	11.80%	28	5.20%	4.10%	18	4.50%	4.50%	56
Median Fund Performance		13.00%	Median Fund Performance		4.50%	Median Fund Performance		4.70%
*ERB also has an 8% actuarial benchmark for funding purposes.								

Land Grant Permanent Fund (LGPF)								
1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
14.50%	14.90%	12	4.20%	3.70%	67	4.20%	3.80%	71
Median Fund Performance		11.90%	Median Fund Performance		4.90%	Median Fund Performance		5.00%

Severance Tax Permanent Fund (STPF)								
1 Year			5 Year			10 Year		
Fund	Benchmark	Ranking	Fund	Benchmark	Ranking	Fund	Benchmark	Ranking
12.80%	15.10%	34	3.20%	3.80%	87	3.30%	3.70%	87
Median Fund Performance		11.90%	Median Fund Performance		4.90%	Median Fund Performance		5.00%